COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF PUBLIC UTILITIES

Investigation by the Department of Public Utilities Upon its Own Motion Commencing a Notice of Inquiry/Rulemaking, Pursuant to 220 C.M.R. §12.00 et seq., Establishing the Procedures To Be Followed in Electric Industry Restructuring by Electric Companies Subject to G.L. c. 164	**D.P.U. 96-100**

COMMENTS OF THE MASSACHUSETTS MUNICIPAL WHOLESALE ELECTRIC COMPANY ON THE DEPARTMENT'S PROPOSED RULES GOVERNING THE RESTRUCTURING OF THE ELECTRIC INDUSTRY IN MASSACHUSETTS

INTRODUCTION

The Department of Public Utilities ("Department") issued proposed rules to govern the restructuring process in Massachusetts, with an explanatory statement, on May 1, 1996 ("Order"). In accordance with the procedural schedule, the Massachusetts Municipal Wholesale Electric Company ("MMWEC") hereby submits its comments on the Department's proposed rules.

MMWEC is a political subdivision of the Commonwealth established by the Legislature to plan, finance and acquire electric power resources on behalf of its member Massachusetts municipal light departments. See St. 1975 c. 775; M.G.L.A. c. 164 App. §1-1 et. seq. MMWEC is a wholesale electric company. It does not sell electricity at retail and thus far has relied on the transmission owned by others to deliver the power it generates and purchases.[1] Accordingly, MMWEC's comments focus on the Department's proposed rules relating to the wholesale electricity market. These issues include (1) market structure, (2) market power, (3) transmission, (4) stranded cost, and (5) local property taxes.[2]

Because its members are municipal light departments, MMWEC is also concerned with the effect of restructuring on municipal light departments. MMWEC agrees with the Department's decision to preserve current jurisdictional bounds and not to impose restructuring policies upon individual municipal light departments. Order at 33. Nevertheless, the rules ultimately adopted by the Department have significant implications for municipal light departments and will affect their ability to survive in a deregulated environment and realize the true benefits of competition. In this regard, MMWEC believes that its comments relative to the wholesale electricity market are also relevant to municipal light departments.

COMMENTS

I. MARKET STRUCTURE

A. Corporate Structure

The Department concludes in its Order that investor-owned electric companies must modify their corporate structure before

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[1] MMWEC is more fully described in its Initial Comments submitted to the Department in this docket on April 12, 1996.

[2] MMWEC incorporates without repeating the comments set forth in its Initial Comments in this docket.

the generation market can be deregulated. Order at 25. The Department found a strong correlation exists between the degree of corporate separation and the level of regulatory supervision necessary to avert market power abuses. Order at 26. The Order defines the minimum acceptable approach as the creation of separate corporate entities, e.g. generation, transmission, marketing, and distribution subsidiaries, under one holding company. Id.

The Department continues to believe that mandatory divesture is not desirable or necessary. Order at 27. Instead, the Department advocates voluntary divesture of generation. Id. The Department's Order contains alternatives designed to provide incentives for voluntary divesture of generating assets. Order at 27, 57.

In MMWEC's view, the creation of separate corporate entities under one holding company, will be only slightly, if at all, more effective in averting market power abuses than the creation of separate functional divisions within a single corporation. Under a holding company structure, the separate corporate entities will continue to share management, shareholders, and consolidated tax benefits and balance sheet. The unregulated generation entity will be competing in markets in which its affiliated transmission entity controls the means of access to those markets. The tax benefits created by the generation facility will be enjoyed by the same stockholders who own the transmission affiliate lowering any taxable income created by the transmission affiliate. This joint control allows for the erection of market barriers and unfair competition. Further, as the Department has recognized such hybrid competitive/regulated entities will tend to subsidize their competitive affiliates with revenues from their regulated affiliates. Intra-LATA competition, DPU 1731, 55 1985. Although the Department's proposed rules of conduct (220 C.M.R. 11.06) help define anticompetitive behavior, it will be difficult for the Department to police interaffiliate transactions and determine whether corporate affiliates are sharing costs, revenues, personnel, or information and thereby inhibiting full competition.

MMWEC supports the Department's proposal to provide incentives for voluntary divesture of generating assets. See Order at 27,57. MMWEC urges the Department to adopt rules prohibiting vertically integrated investor-owned utilities from competing for retail customers outside their service territory, continuing to regulate the rates of generators and marketers with the regulated affiliates and offering rate of return incentives for companies which choose to divest.

B. Independent System Operator

The Department's vision for a competitive generation market is characterized by an independent system operator ("ISO") that would continue to operate the entire New England bulk power system as a single control area. Order at 13. The ISO must be responsible, at a minimum, for those activities necessary to ensure that reliability standards will continue to be met. Id. The Department's initial view is that exclusive ISO control over the dispatch of all generating facilities would not be necessary to achieve reliability standards. Order at 15.

MMWEC concurs that a competitive market structure requires the establishment of an ISO. Contrary to the Department's initial view, however, MMWEC believes that, to maintain reliability, the ISO must control all generation. The ISO must be able to match generation and loads throughout the control area. To accomplish this, the ISO must not only know what generating units are in operation at all times, but also have the ability to increase or decrease generation in order to match loading conditions. To ensure reliability, the ISO must be able to respond immediately to local conditions. For example, extreme weather conditions could cause a substantial loss of load on a portion of the New England electric grid. The ISO must have the ability to back down and shutdown any and all generation in order to meet such contingencies. Because it is not possible to predict where such conditions may occur, the ISO must have control over all generation to maintain system reliability.

The Department's vision appears to permit the power exchange and perhaps even individual generation owners to nominate dispatch schedules without regard to overall system reliability, load or economics. Allowing market participants freely to dispatch their own units has potentially significant reliability and economic efficiency ramifications. It is important to distinguish bilateral contractual arrangements, savings shares, and other financial arrangements, from the physical dispatch of generating resources by the system operator. Bilateral contracts transfer the right to capacity and associated energy from a given generating resource from one participant to another. They need not and should not effect the actual dispatch of units. For economic efficiency reasons, the dispatch must be driven by the marginal operating costs of the various resources available for dispatch. Putting operational considerations aside, the system operator should physically dispatch generating resources in ascending order of their operating costs without regard to specific bilateral arrangements between market participants. In order to maintain reliability, this economic dispatch must be adjusted to reflect operational considerations. The bilateral financial arrangements between individual participants are solely for cost accounting and energy balancing purposes. The actual dispatch of generating resources by the system operator is independent of these bilateral contracts.[3]

For reliability reasons, the physical dispatch must be driven by operational considerations. For economic efficiency reasons, the dispatch must be driven by the marginal cost of

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[3] The Order notes that increased bilateral arrangements among participants in recent years have resulted in a "savings fund" approaching zero. Order at 17. Numerous factors have also contributed to reduced savings fund levels. The surplus capacity situation in New England, the firm Hydro-Quebec contract and the low fuel costs of marginally operated units have been major contributors.

available units. Resources bid at or below the clearing price are dispatched while those above are not. For these reasons, market participants cannot be allowed freely to nominate generation for dispatch based on purely financial considerations.

MMWEC also questions the need for an ISO separate and apart from the power exchange. See Order at 23. The ISO would need all the information available to the power exchange for both scheduling and settlement purposes. This is particularly true if, as MMWEC understands it, the power exchange would replace NEPOOL economy transactions, unscheduled outage service, and deficiency service. Here again, it is important to distinguish between the physical dispatch and bilateral transactions. The Department must be weary of creating a situation in which the ISO is not completely aware and in control of the state of the New England power supply system.

B. Market Power

The Department recognizes that true independence of the ISO and power exchange from market participants is important to resolving market power issues. Order at ii, 14, 23. MMWEC concurs that the ISO/power exchange structure truly must be independent from the owners of significant generation and transmission facilities.

In structuring the ISO, the Department must ensure that large market participants do not control the ISO either through the ISO's voting structure or through contractual arrangements between the market participants and the ISO. Proposals regarding the establishment of an ISO have suggested a separate corporate entity in which the employees would have no relationship to the market participants but the Board of Directors would be made up of market participants. Under another scenario, market participants would dictate the terms by which the ISO can operate. In MMWEC's view, neither of these models provide sufficient independence to resolve market power issues. MMWEC urges the Department to adopt a rule requiring the ISO to be structured so that large market participants do not have control either directly through the ISO's governance structure or indirectly through contractual arrangements which allow those participants to fashion the ISO's rules and protocols.

MMWEC also concurs with the Department's finding that the high concentration of market share controlled by a few participants in New England permits only a few firms to gain undue market power. Order at 29. MMWEC believes that New England is the relevant geographic market in measuring market power. The capacity of the ties between NEPOOL and adjoining control areas is limited. As a result of these tie constraints, only limited transactions with neighboring areas can occur. Therefore, the relevant geographic market for measuring market power does not extend beyond New England.

As indicated in MMWEC's initial comments, a utility's market share of uncommitted capacity is an indicator of its ability to dominate firm sales in the short-run market. See MMWEC Initial

Comments at 9. In New England, two utilities, Northeast Utilities and New England Electric System, control over 85% of the uncommitted capacity. See Initial Comments of Eastern Edison Company at 9. It is clear that the Department needs regulatory devices to curb potential abuses of the market power these utilities possess.

MMWEC urges the Department not to rely on the anti-trust laws to resolve market power issues. See Order at 27-29. The anti-trust laws offer only blunt and expensive remedies which may be wholly inappropriate to address subtle market power abuses. In MMWEC's view, market power concerns are better addressed by strong incentives for voluntary divestiture and an ISO which is truly independent from generation and transmission owners. In addition, MMWEC urges the Department to adopt a rule containing a mechanism by which market participants can monitor for abuse of market power with appropriate penalties and sanctions. For example, generators with potential market power should be required to report information concerning their bids and the availability of their facilities which would permit identification of market abuses.

C. Transmission

MMWEC concurs in the Department's conclusion that the ISO must obtain control over transmission facilities from the owners of those facilities. Order at 14. See MMWEC Initial Comments at 12. MMWEC also supports the Department's proposal for a regional network transmission tariff. A regional network tariff would help alleviate competitive distortions caused by pancaked transmission tariffs. Order at 21. See MMWEC Initial Comments at 11-12.

The Department proposed regional network transmission tariff includes zoned rates with adders and subtractors to reflect constraints. Order at 21. The Department should take special care to insure that zoned rates do not have anticompetitive impacts similar to pancaked rates. Bottlenecks in transmission tend to occur at interfaces between existing service territories. Zones reflecting existing constraints could therefore reflect, at least initially, existing service territories. As a result, zoned rates could have the similar anticompetitive effects as pancaked transmission tariffs.

MMWEC urges the Department to adopt or foster incentives to eliminate transmission constraints, and ultimately the zones which those constraints reflect.

According to the Order, the Department favors sunsetting existing preferential transmission pricing arrangements. Order at 21. The phaseout of these arrangements may not be consistent with a competitive market until zones are eliminated from transmission tariffs and the generating units associated with those arrangements are retired. In particular, the transmission arrangements associated with large jointly owned "pool-planned" facilities served to induce dispersed investment in those facilities and are existing contractual commitments. Jointly owned units are by their very nature often located remote from the loads of their owners. For example, MMWEC has ownership interests in jointly owned facilities located in Connecticut, Maine and New Hampshire. The existing transmission arrangements to deliver the output of those facilities is part of the economics upon which MMWEC's decision to invest in those facilities was based. In accordance with the broad transition principle enunciated in Electric Industry Restructuring, DPU 95-30 (1995), the Department should continue to honor those arrangements. In addition, the termination of those dispersed arrangements would directly impact the value of those facilities and would likely create an additional barrier to the divestiture of generating units. Order at 22.

The Department recognizes that New England is a regional market and that the regulatory responsibilities for transmission in interstate commerce resides with FERC. Order at 18. A regional solution to the transmission issues will ultimately require FERC approval. The regional market requires a regional ISO/PE structure and may also require the formation of an acceptable regional transmission group ("RTG"). It will likely also involve reformation of NEPOOL. Additionally, the siting, environmental and eminent domain laws may require amendment to recognize the regional nature of the electricity market.

Based on those considerations, MMWEC urges the Department to be somewhat flexible in timing the introduction of retail choice in Massachusetts. Because the Department's vision for a restructured electric industry in Massachusetts depends to some extent upon the actions of other regulators, the Department must ensure that its timetable is consistent with those of FERC and possibly of regulators in the other New England states. In particular, MMWEC believes that wholesale competition in the New England market should be allowed to develop fully before retail competition is introduced.

D. Stranded Costs

As stated in its MMWEC initial comments, MMWEC and its member and participant municipal light departments must recover all costs which are stranded as the result of electric industry restructuring. MMWEC and the municipal light departments do not have stockholders who can absorb stranded costs.

MMWEC agrees with the Department that stranded cost recovery must include a reconciliation method to correct for major errors in projections of future market conditions with the Department. Order at 54; MMWEC Initial Comments at 13. Because MMWEC and the municipal light departments do not have shareholders or retained earnings, however, reconciliation methods as applied to them cannot permit underrecovery of stranded costs.

The method the Department proposes calls for the Department to review the difference between projections and actual experience at two, five and ten years subsequent to the date that the stranded cost charges are implemented. Order at 62. In addition, the Department's methodology includes a recovery bandwidth for the difference between projections and actual experience that broadens over time. This bandwidth recovery methodology cannot work for MMWEC and the municipal light departments because substantial underrecovery of stranded costs could occur, especially during the later years of the recovery period. Public entities without equity require a much closer correlation, and perhaps, more frequent adjustment.

MMWEC agrees with the Department that nuclear units have unique costs and uncertainties associated with their operation, safety and reliability. It supports the Department's proposal to allow collection of nuclear decommissioning costs over the entire lifetime of the original operating license. Order at 58. MMWEC also urges the Department to consider a rule which takes into account the unique issues associated with nuclear generation beyond decommission costs. As a joint owner of nuclear facilities, MMWEC is concerned about the financial viability of its investor-owned counterparts and the need to operate nuclear plant safely. Accordingly, MMWEC urges the Department to consider an extended transition period for all stranded nuclear costs.

E. Local Property Taxes

The Department views the transition period for restructuring as a transition period for municipalities as well. Order at 64. It proposes that when a utility recovers stranded costs in excess of market value, property taxes should be based on the sum of market value and stranded cost collection. Id.

The Department's Order does not account for low cost assets that increase in market value as a result of restructuring. See MMWEC's Initial Comments at 14. If stranded cost recovery is used to justify existing valuation of high cost plants, then an offsetting credit associated with low cost plant should also be considered. Id. MMWEC urges the Department to adopt a rule incorporating offsetting credits for low cost plants.

III. CONCLUSION

The Department's proposed rules are consistent in many respects with MMWEC's vision for a competitive wholesale generation market. To ensure full and fair competition while maintaining the reliability and inherent economics of the regional power supply system, MMWEC urges the Department to modify or adopt additional rules designed to accomplish the following:

1. Create incentives which encourage investor-owned companies which own a significant amount of generation or transmission relative to the size of the market to divest those assets. Such rules include prohibiting vertically integrated investor-owned entities (including separate corporate entities under one holding company) from competing for retail customers outside their service territory; continuing to regulate the rates of generators and marketers with regulated affiliates; offering rate of return incentives for large companies which choose to

divest; and limiting recovery of stranded costs by those which do not.

2. Vest exclusive control over all generation in a truly independent ISO;

3. Ensure that large market participants cannot control the ISO either directly through its organizational structure or indirectly through contractual arrangements which allow large market participants to shape the ISO's rules and protocol;

4. Measure market power by reference to the New England geographical market with particular attention to the concentration in New England of uncommitted capacity in two utilities;

5. Create a mechanism by which market participants can monitor for abuse of market power with appropriate penalties and sanctions;

6. Create incentives to eliminate transmission constraints especially between existing service territories;

7. Honor existing transmission arrangements associated with jointly owned generating facilities;

8. Coincide with the time tables of the FERC and regional regulators and legislators;

9. Take into account issues associated with nuclear generation, including an extended transition period for nuclear stranded investments; and

10. Yield a net reduction in local property tax payments by utilities.

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DATED: May 24, 1996

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